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Institutional Change and Poland's Economic Performance since the 1970s

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Chapter 8

Summary and Conclusions

This final chapter gives an overview of the main conclusions and policy implications of this study on institutional change and Poland's economic performance since the 1970s, and an attempt is made to answer the main question of this thesis: *To what extent have incentives and transaction costs changed in the Polish economy and influenced economic performance in the period 1970–2000 and how can these changes be explained with the help of New Institutional Economics?* Two periods were taken into consideration. The socialist system, which existed until 1989, and the period of market construction since 1990. The main question was divided into sub-questions. Concerning the socialist system, to what extent can transaction costs and incentives explain its demise, and how did they create the conditions for institutional change towards a market economy? How did the situation at the end of the socialist system influence economic performance at the beginning of the 1990s, and how did institutional change proceed and transaction costs and incentives develop during the 1990s?

Tools of New Institutional Economics (NIE) have been applied in order to try to find an answer to the research question and analyse the process of institutional change. NIE analyses economic problems from a multidimensional point of view. A focal point was how the “legacy of the past” can be taken into account when explaining the decline of the socialist system in Poland and analysing the process of institutional change in the 1990s.

8.1. Summary of main findings and conclusions

Formal and informal institutions (rules of the game) provide incentives for economic activity. Thus, when institutions change, incentives for economic activity also change. Transaction costs influence the payoffs of undertaking economic activity, and determine which type of governance structure is the most efficient. The level of transaction costs is influenced not only by institutions influencing the value in the public domain, but also by “hardware” like physical infrastructure and by enforcement of the rules of the game by “institutional governance”. Institutions should be stable and reduce uncertainty, in order to stimulate economic activity. However, inefficient institutions may survive, as people get used to them (mental models), not all mistakes are uncovered, and strong interest groups may defend a status quo.

In general, high transaction costs negatively influence economic activity, while the same counts for weak incentives. But when transaction costs are high and incentives strong, the influence on economic activity depends on which factor has the strongest influence.

Generally speaking, a planned economy can function appropriately at early stages of economic development or when market institutions are not developed or fail. Thus, just after World War II the model of central planning could provide satisfactory economic performance, especially in the period of post-war reconstruction. However, when the number of transactions increase, the planned economy is expected to face increasing (marginal) transaction costs, as there are diseconomies of scale to planning. Then a more decentralised economic system, like a market economy, is needed to lower transaction costs. When transaction costs increase, there is larger value in the public domain, negatively influencing incentives for productive activity, as more opportunities for rent-seeking appear. This is a theoretical explanation for the economic stagnation in Soviet-Type Economies (STEs) that appeared in the 1970s and 1980s.

The socialist system was inefficient compared to developed market economies. A question is why inefficient institutions in socialist countries could survive for such a long time. Until the 1960s economic performance in STEs was at an acceptable level. When economic problems appeared, people had already got used to the system. Furthermore, the Communist Party in fact monopolised information, and had a strong ideological commitment to the socialist system. The influence of the Soviet Union limited the room for change in Poland to a large extent. Due to control of media, many mistakes remained uncovered. When the power monopoly of the Communist Party was broken, market institutions that would increase efficiency could be introduced. However, there is a free-rider problem with introducing them, as market institutions have features of a public good. This is because they are accessible for free without reducing the opportunities for use by others. Self-interest and distrust make the problem bigger, while trust and process-regarding preferences (e.g. ideology) can overcome the free rider problem. However, even when the free-rider problem is overcome, there remains uncertainty about the outcome of institutional change. No-one is able to completely grasp the complex nature of institutional change or foresee which institutions are most efficient, because of many unknowns, while much can go wrong in the process of creation and implementation.

It is expected that transaction costs increase when the introduction of market institutions is speeded up. When there is high uncertainty about institutional change, people fall back on mental models developed under the old system, leading to adverse reactions to the incentives given by developing market institutions. This creates an institutional disequilibrium. As many people had "system-specific" skills and contacts, they had an interest in protecting old (inefficient) institutions, which slowed down institutional change. Thus, for a certain period old "degenerating" institutions were likely to co-exist with new developing institutions. This was accompanied by lack of certain institutions (institutional vacuum).

Furthermore, value in the public domain is expected to increase. During the privatisation process the opportunities for rent-seeking increased, and there were problems with the enforcement of market rules of the game as "institutional governance" was weak. The increasing transaction costs and adverse incentives may have contributed to the fall in output

at the beginning of the 1990s, while incentives for economic activity due to more economic freedom counteracted this tendency.

Generally speaking, transaction costs increased and incentives weakened through time in the socialist system. This was a consequence of the system weakening from classical socialism, via reform socialism to “decaying” socialism. Increasing transaction costs and weakening incentives contributed to deteriorating economic performance, and, together with other factors like the large foreign debt and the extensive growth path, resulted in economic stagnation. In the period of classical socialism, which lasted more or less until the end of the 1960s, transaction costs were relatively low and incentives relatively strong, as the Central Committee had an encompassing interest in good economic performance and public property and planning were “strong”. In the period of reform socialism, which in Poland started in the 1970s, transaction costs increased and incentives weakened. This is connected with the weakening of the planned economy, making the solving of the allocation problem more difficult. Reforms and decentralisation *de facto* led to a dispersion of the characteristics of property rights. In other words, lower levels in the hierarchy obtained part of *usus* (the right to use) and *usus fructus* (the right to pick the fruits). As a consequence, in accordance with what Olson argues, there was a change from encompassing interest to narrow interest. The Central Committee had an interest to look at total economic performance, while individuals were interested rather in maximising their own welfare, eventually at the cost of overall economic performance. Furthermore, the dispersion of property rights made it more unclear who was in control over property rights, while the principal-agent problem increased in a situation where it became more unclear who is the principal. Thus, it can be argued that value in the public domain increased, leading to increased rent-seeking, higher transaction costs and weaker incentives for productive economic activity.

The socialist system was adaptively inefficient. The institution of public property provided weak incentives for innovation, since benefits became public property and costs and risk were born by the innovator. Another reason for adaptive inefficiency was the impossibility of experimenting with different forms of property rights, as state ownership was sacrosanct.

Communist ideology had never been very strong in Poland, and the Gierek administration tried to motivate people with economic incentives. This supported a development towards narrow interest. Furthermore, support was “bought” by promising higher standards of living and a social contract of solving political conflicts non-violently. Investment and consumption was financed by foreign loans. However, the strategy of building up industry for exports failed due to various reasons. This may not have been so much the result of the waste of investment due to weak incentives, as the oil crises and strong internal demand negatively influenced opportunities for exports. The oil crises of 1973 and 1979 caused Western economies to enter a recession, lowering the demand for Polish export products. On the other hand, the increased expectations of society had to be fulfilled. Because of this many products were not exported, as they were consumed on the domestic market. This created a problem with repaying the foreign debts. Belief in the system started to weaken as economic problems continued, especially towards the end of the 1970s. During this period the labour movement in the form of Solidarity gained much influence, weakening the power of the Communist Party.

The 1980s were a period of “decaying” socialism, where the economic policy seemed to be “keep the boat from sinking”. Transaction costs increased more and more, and incentives weakened. By way of Martial Law, which went into force on 13th December 1981, an attempt was made to break the power of the, by that time, legal labour union Solidarity. It is difficult to find out whether it was the Soviet Union that inspired this or not, but as a consequence the Communist Party itself weakened very much. Many members had been active in Solidarity, and in 1982 many people left the Party. After a while labour again gained more power, and in the process of reform attempts in 1982 and after, labour and management of state-owned enterprises (SOEs) obtained more influence. In other words, they had more control over the characteristics of state property. As a result, property rights were more vaguely defined, leading to more value in the public domain. From 1982 an attempt was made to introduce more market into the economy, and the system of directive planning was abolished. Plan bargaining was replaced by regulation bargaining, which was accompanied by higher transaction costs. Shortages increased, which led to higher transaction costs from the sides of both producers and consumers. Theoretically, in a planned economy there are no transaction costs involved in activities such as stock procurement and selling the product. However, due to shortages it was never clear how much of the needed input could be obtained at what moment. This led to hoarding and the development of an informal market between firms, accompanied by high transaction costs. Also many other transaction costs increased. For consumers the consequence of shortages was that more and more often queuing and informal markets became the distribution mechanism. It was quite common that people had to queue 2–3 hours per day for the necessities of life. Such a situation was frustrating, and contributed to general dissatisfaction. Belief in the socialist system weakened, also among members of the Communist Party. In other words, the institutional disequilibrium became larger.

The weakening of the socialist system by way of de facto dispersion of property rights, weakening of the Communist Party, the abolition of central planning and the disappearance of the belief in the system were factors that created a situation of “decaying” socialism in the 1980s. Transaction costs increased, incentives weakened, and economic stagnation seemed to be a permanent feature. This created fertile ground for the creation of a market economy in the 1990s. Economic factors alone cannot explain the direction of change. The development of an economic interest among the ruling elites in a more market-oriented system was important. This, and the strong labour movement, lowered the political transaction costs of change significantly. However, the non-interference of the Soviet Union in Polish internal affairs also lowered these political transaction costs.

The situation at the end of the 1980s was one of neither plan nor market. With the peaceful power transfer to the Solidarity movement in 1989, when a coalition with the Communists was formed, the task of the Solidarity led government was to develop a program to improve economic performance. As transaction costs increased and incentives weakened under socialism, an implicit aim of transformation was to lower transaction costs and strengthen incentives. Although theoretically there may have been other options, it can be argued that the construction of a market was chosen as there were no other feasible alternatives. Reforming socialism was not a real alternative, as there was no-one to do this job.

The reformers were quite optimistic about the expected results of the Balcerowicz plan under which a market economy would be introduced in a short period. With the advantage of hindsight, the tools of NIE can be used to explain why the fall in output was larger than expected at the beginning of the 1990s, and why Poland's economy started to grow again after a short recession in comparison to other transforming former STEs.

As informal institutions change more slowly than formal institutions, mental models developed under the old system play an important role in the development of the new system (path-dependency). This means that fast institutional change is difficult. Theoretically, formal rules can be changed at once, but implementation takes time because economic subjects have to learn, interpret and apply the new rules and to change their behaviour. Institution building and the creation of "institutional governance" is very costly (high fixed transaction costs of institutional change), which implies that these sources cannot be used for other purposes, negatively influencing economic activity. Although the Polish transformation was called "shock-therapy" as opposed to gradualism, these labels are not proper. Some institutions changed quickly, while others changed slowly. Thus, the label "shock" or "gradual" depends on which institutions we are talking about.

The development path towards a relatively strong market economy was not obvious, as examples of former Soviet republics show. An important factor strengthening the economic system immediately was the macroeconomic stabilisation policy in the form of price and trade liberalisation. Although this caused a deepening of the recession in 1990–1991 on the one hand, it reduced the opportunities for rent-seeking activities created by price regulations and reduced the remaining shortages immediately. Price liberalisation means the privatisation of property rights (characteristics of property) that the government possessed with respect to price regulation, stimulating the development of a market economy. Trade liberalisation provided strong incentives for small business to develop, while they faced low transaction costs, as little regulation existed. As a result, a private sector was firmly established. When opportunities for rent-seeking are reduced (lower value in the public domain), wealth maximising individuals use their efforts for productive rather than redistributive activities.

Uncertainty about future institutional change was very high at the beginning of the 1990s, while the economic system faced an institutional vacuum and an institutional disequilibrium. A mix of socialist and market institutions existed and many market institutions existed in an "embryonic" form or did not exist at all. When there is uncertainty, economic actors fall back on their mental models, which in this case took shape under socialism. Such a situation created many adverse incentives for economic behaviour and led to high transaction costs in economic exchange in the process of institutional change (*e.g.* privatisation) and restructuring of SOEs. As a consequence, output declined. This effect was strengthened by factors such as a lack of social capital and a lack of skills needed for a market economy. However, due to the immediate system strengthening, the fall in output was not as deep as it could have been.

Transition has come to its end when a "normal" economic system exists where transaction costs are low and incentives are strong, while informal institutions support formal institutions. Although many steps in this direction have been made, transition still proceeds in many fields.

An example is logistic development, where Poland lags 10 to 30 years behind developed market economies. However, the development of logistics creates opportunities for finding transaction cost lowering solutions and provides incentives for step-by-step institutional improvement. It is suggested that small firms should start to co-operate with each other, in order to survive increasing competition from larger companies offering logistic services. This seems also to be necessary, as the "institutional vacuum" is becoming smaller with the introduction and implementation of many standards (e.g. health, safety and environmental standards) in the process of EU accession, increasing the costs to smaller firms relatively faster than to larger firms.

At the beginning of the 1990s transaction costs to SOEs increased, while small newly established private business faced low transaction costs and strong incentives. When property rights became more certain, the institutional vacuum became smaller and part of the (privatised) state sector adapted to the new circumstances, causing transaction costs to decline. A good example of a strengthening institution leading to lower transaction costs is the banking sector. However, as is suggested by empirical research (see the Appendix), in the second half of the 1990s some transaction costs increased, at least for small firms. It may be that the closing of the institutional vacuum, e.g. in the form of the introduction and enforcement of new taxes as well as environmental and health regulations posed problems for them. The data also suggest increasing transaction costs for firms with more than 20 employees. These transaction costs concern inefficient public administration, unclear laws, law enforcement, the process of creating legislation, corruption, theft, and increasing problems with collecting payments from trade partners. Furthermore, trust and the propensity to co-operate remain low. Trust in different levels of government among entrepreneurs is very low, posing a threat to continuing economic growth. Some trust in banks, as well as process-based (personal) trust in suppliers and clients, exists, suggesting some prospects for developing new economic ventures.

8.2. Some implications

Tools of NIE have been used to analyse system change in Poland since the 1970s. It has helped to explain why the socialist system stagnated economically, and how weakening incentives and increasing transaction costs contributed to the demise of the system, being an explanatory variable in addition to political factors. Furthermore, it explains why the transformation strategy was accompanied by a decline in output, and why the economy entered a path of economic growth rather quickly. It also helps to indicate which challenges have come up that may hamper future economic growth.

A question is how future institutional change will proceed. A market has been introduced, generally speaking lowering transaction costs and strengthening incentives compared to the socialist system when the economic system strengthened in the 1990s. However, although uncertainty about the direction of institutional change has been reduced significantly, there is still a long way to go as only thirteen years have passed since the introduction of the Balcerowicz plan. As much change still has to take place, uncertainty remains.

Among others, weak “institutional governance”, interest groups and a lack of transparency hamper the introduction of more efficient institutions.

Poland's efforts for EU accession create incentives for the development of strong institutions and good governance practices. At the moment (the year 2003) Poland is in the process of preparing accession to the European Union. In fact, this is also a process of institutional change accompanied by many uncertainties. There seems to be less uncertainty in this process than at the beginning of the 1990s, because there are established EU institutions to refer to and adaptation to EU institutions has been proceeding for many years. However, the existing mental models, which still find their roots in the socialist system, as well as the inefficient formal institutions and “institutional governance” still existing, create the danger that an “inefficient copy” of EU institutions will be introduced. This is not an unrealistic scenario, as in the last few years many laws have been passed and negotiations with the EU have finished, of which hardly anyone can predict what will be the effect, simply due to the huge amount of changes, not mentioning other factors. “Inefficient copies” of EU institutions are more likely, if these institutions are introduced without taking Polish reality into consideration.

Furthermore, EU institutions also have to be changed in the process of its enlargement, creating much uncertainty. For this reason experience from the transformation to a market economy gained up till now may be invaluable in facing the challenges created by the aspirations of joining the EU. As EU accession implies a new kind of transformation, lessons from the process of institutional change can be drawn, in order to prevent the type of problems that came up at the beginning of the 1990s. Although many firms are prepared for changes, due to the proceeding transformation, many are likely to have to restructure and to invest in new trade relations when Poland joins the common market. In the short-run there may be negative economic effects, while positive economic effects will be felt only in the medium-term as a result of evolutionary institutional change, under the condition that Poland is able to use the opportunities created by EU membership.